

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NED:BOS:TL-N-2939-98
CWMaurer

date:

to: Appeals Division, [REDACTED]
Attention: [REDACTED]

from: District Counsel, New England District, Boston

subject: [REDACTED] **Abandonment Losses**
Pattern language for statutory notice of deficiency

Taxpayer: [REDACTED]
UIL: [REDACTED]

<u>Years</u>	<u>Proposed Deficiencies</u>
[REDACTED]	\$ [REDACTED]
[REDACTED]	[REDACTED]

DISCLOSURE STATEMENT

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We have been advised by Robert Gorey, Appeals ISP Coordinator for Property and Casualty Insurance, that your office is considering issuing a statutory notice of deficiency to the above-named taxpayer which will also disallow claims for refunds covering losses from the abandonment of intangibles using the

basis step-up provided by section 1012(c) of the Tax Reform Act of 1986.

As you know, this issue has received a good deal of attention, and our memorandum has been reviewed by the National Office. If you should be contacted by any other office seeking pattern language for this type of adjustment, we request that you refer them to this office so that we may coordinate this matter with the National Office.

We have not reviewed the administrative file in this case. An Executive Summary of the Appeals Division Supporting Statement identifies four issues: two resolved and two unresolved. [REDACTED]

[REDACTED]. The second resolved issue concerns the administrative expenses includible in the computation of the special deduction.

The first unresolved issue is whether coordination of benefit provisions create salvage and subrogation. The second unresolved issue is the abandonment loss deduction. These abandonment loss deductions were claimed on amended returns filed while the case was under consideration by the Appeals Division, and covered subscriber base and workforce in place intangibles.

1. Abandonment loss issue. A draft notice of deficiency indicates that the taxpayer filed claims for refund as follows:

Date of claim	Taxable year	Amount of refund
[REDACTED]	[REDACTED]	\$ [REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]

According to the Executive Summary, the amounts claimed for abandonment losses are as follows:

[REDACTED]	\$ [REDACTED]
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The Executive Summary at page 13-1 indicates that the taxpayer determined a [REDACTED] fair market value for the

subscriber base of \$ [REDACTED], or \$ [REDACTED] per member, and a fair market value for the assembled workforce of \$ [REDACTED].

The taxpayer issues group contracts covering multiple subscribers. From the description in the Executive Summary, it appears that the taxpayer determined a valuation for its entire subscriber base, which was then divided by the number of subscribers to produce an average value for each subscriber. That average value was then applied to the number of subscribers covered by each group contract to produce a value for the group. "Abandonment" losses were claimed as subscribers failed to continue their coverage from one year to the next for any reason. However, it is not clear whether the losses were claimed when an individual subscriber failed to renew coverage, even though the group contract remained in effect, or whether the losses were claimed when a group contract was not renewed. The District reviewed the claims and determined that a reasonable value for the subscriber base was \$ [REDACTED] rather than \$ [REDACTED].
(Page 13-3.)

In valuing the taxpayer's workforce, the taxpayer's appraiser divided the employees into four groups and determined an average value for the members of each group. "Abandonment" losses were claimed for each individual employees that left the workforce, using the average value applicable to that employee.

As you know, in a memorandum dated March 7, 2000, Daniel Black, the National Chief of Appeals, suspended settlement of the [REDACTED] partial abandonment loss issue. The memorandum indicates that in cases where the taxpayer claimed the losses on its original return, the taxpayer can concede the issue and reserve the right to file a claim, or the Service will issue a statutory notice of deficiency. Where the taxpayer has filed a claim but does not agree to the disallowance of the claim, the Service will issue a notice of claim disallowance.

In the present case, it appears that all of the abandonment losses were submitted as claims for refunds. It is our understanding that the Appeals Division will disallow the full amount of the loss, in accordance with the directions of Mr. Black's memorandum of March 7, 2000.

The following language may be used as an explanation for the adjustment:

In making this determination of your income tax liability, careful consideration has been given to your

claim for refund filed on _____ for a refund of _____ for the taxable year 199X. It is determined that the amount claimed as a deduction for an abandonment loss is not allowable because it has not been established that any abandonment occurred during the taxable year, or that any loss was sustained. Accordingly, taxable income is increased \$_____.

In addition, it is determined that your specific individual customer or employee contracts are components of intangible assets which constitute single indivisible assets, including customer-based or workforce intangibles. Accordingly, no current loss deduction is allowable upon the termination or nonrenewal of a single subscriber relationship, employee relationship, or similar component of these indivisible assets.

In addition, the basis step-up provided by section 1012(c)(3)(A)(ii) of the Tax Reform Act of 1986 is available solely for purposes of determining gain or loss upon the sale or exchange of assets, not for purposes of determining amounts of depreciation or for other purposes. The basis step-up is not available for annual current deductions based upon the termination or nonrenewal of specific individual customer or employee contracts, because such annual current deductions are equivalent to the amortization of the single indivisible assets.

In addition, since no annual current deductions were claimed for the termination or nonrenewal of specific individual customer or employee contracts for two or more consecutive taxable years, such contracts have been treated as single indivisible customer-based or workforce intangible assets. This treatment constitutes a method of accounting. The deduction of annual current amounts constitutes a change in method of accounting, which is not allowable without the consent of the Commissioner.

The first paragraph covers the Government's position that there is no legal basis for claiming an abandonment loss for an individual component of an indivisible asset ("it has not been established that any abandonment occurred"), and that the value of the abandoned assets has not been established ("... that any loss was sustained"). The second paragraph more specifically covers the mass asset theory, and the third paragraph covers the Government's position that the basis step-up does not apply to

partial abandonments. The fourth paragraph covers the change in accounting method issue.

Again, we emphasize that we have not reviewed the administrative file. The proposed language set forth above is pattern language describing the types of adjustments that may be appropriate in these cases. This language may require modification depending on the specific facts of your case.

2. Coordination of benefits issue. This issue was submitted to the National Office for Technical Advice, which sustained the position of the examining agent. The discussion of the coordination of benefits issue in the Executive Summary follows the factual description from the Technical Advice memorandum.

We have reviewed other cases that raised this issue, where the taxpayer made factual assertions similar to the statements in this case, which later proved to be inaccurate or inconsistent with the taxpayer's actual practices and records. Accordingly, we do not recommend that any factual concessions be made based upon the facts described in the Technical Advice memorandum.

a. The taxpayer's administrative practices. The taxpayer describes a "pursue and pay" method of administering claims, and a "pay and pursue" method, and suggests that it follows both methods simultaneously and indiscriminately. From this the taxpayer argues that since the Government agrees that subrogation may arise in the pay and pursue situation, it is unreasonable to distinguish one method from the other since the taxpayer could have used either. The legal response to this argument is that there are legal distinctions between the two methods, despite the similarity of the verbal description ("pursue and pay"/"pay and pursue"). Subrogation requires a payment, and thus can arise only in a pay and pursue situation. Factually, the taxpayer's assertion is not consistent with the cases we have seen. During this period, these organizations tended to follow the "pursue and pay" method purposefully and exclusively. In other words, the organizations reviewed claims to determine whether there was duplicate coverage before any payment was made, and then paid only the amount that was due as the secondary carrier. No amount was ever recoverable from the primary carrier, because no payment was made for that portion of the claim. "Pay and pursue" only occurred by accident, where information was inaccurate or incomplete.

b. The taxpayer's accounting records. The taxpayer asserts it recorded the full loss incurred, without regard to whether there was duplicate coverage. (Page 5-2.) This is a misleading overstatement. In our experience, the full loss was only recorded in individual claims files, which never entered into the claims data that was used for estimating reserves. It never became part of the taxpayer's financial or accounting records.

c. The computation of the taxpayer's reserves. Most taxpayer's employ an actuarial estimation technique based upon payment data for prior periods. Accordingly, transactions are only taken into account to the extent they generate an actual cash payment. The determination whether a "subrogation" transaction was taken into account, and thus qualifies for the special deduction, depends upon whether the transaction generated a cash payment. By definition, "pursue and pay" transactions never generate a cash payment by the taxpayer, and thus never enter into the computation of its reserves. This conclusion is corroborated by the method used by these organizations to determine the amount of their special deduction. Rather than reviewing the claims data base that was used to prepare the reserve estimates and extracting the coordination of benefits amounts included in that data base, they instead back into a coordination of benefits amount using the individual claims files for subsequent periods. In other words, since they did not anticipate making any payments on claims covered by other insurers, the amount they reserved for those claims was zero. However, by reviewing the actual payments subsequently made by the other insurers, they "reconstruct" a figure for the amount they could have paid.

d. The adequacy of the taxpayer's disclosure to state regulators. The three items previously described -- the taxpayer's administration practices, accounting records, and method of computing reserves -- all go to the factual issue whether the taxpayer makes any payment. Without a payment, subrogation cannot arise. The regulations regarding the special deduction include a safe harbor provision which requires disclosure to the state insurance regulator of the extent to which subrogation was taken into account in determining unpaid loss reserves. Generally, these organizations have submitted some letter to the regulator which purports to make the required disclosure. We have reviewed a number of these letters, which follow a similar pattern. In some cases, the examining agent has conceded that the taxpayer satisfied the disclosures requirement because a letter was in fact submitted to the regulator, but the content of the letter is critical. Merely submitting a piece of

paper is not sufficient. The letters we have reviewed are generally inadequate. The three items discussed above support this issue also, because if no payments were ever made, no amounts were ever entered into the data base from which reserves were estimated, and thus no amounts were taken into account in determining reserves.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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[REDACTED]

[REDACTED]

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Assistant District Counsel

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